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SENSITIVE

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SUBJECT: SECOND MEETING OF TREASURY-FINMIN "GROUP FOR GROWTH"

This cable is Sensitive but Unclassified, please protect accordingly.

¶1. (SBU) SUMMARY: Treasury U/S for International Affairs John Taylor, Ministry of Finance Treasury Secretary Joaquim Levy, and Economic Policy Secretary Marcos Lisboa presided on April 19 in Rio de Janeiro over the second meeting of the Treasury/Ministry of Finance Group for Growth (GfG), an outcome of the June 2003 summit between Presidents Lula and Bush. The GfG meeting's main themes were infrastructure investment and access to credit; prospects for growth in both countries were also presented. This cable reports on the extensive general discussion of Brazil's economic situation and the GoB policy agenda. Lisboa pronounced Brazil's 2002-2003 macroeconomic stabilization efforts a success, with the current sharp drop in inflation, stable debt-to-GDP ratio, and lowest real-interest rates in a decade. Levy added that Brazil is now less vulnerable to external shocks, thanks to to lower exchange-rate volatility, reductions in dollar-based debt, and increased exports. The GoB officials maintained their expectation of 3.5% economic growth this year and claimed that solid recovery began in the second half of 2003. Lisboa also focused in detail on the GoB's microeconomic and structural reform agenda, which aims to sustain growth by decreasing banking spreads, creating incentives for entrepreneurship, sparking innovation, and providing an affordable social-safety net. Levy addressed the fiscal situation in more detail, discussing debt-servicing, the rising tax burden, and falling central-government investment levels. He said the single biggest fiscal challenge facing the GoB is the social-safety net. END SUMMARY.

Background

¶2. (U) Treasury U/S for International Affairs John Taylor, Ministry of Finance Treasury Secretary Joaquim Levy and Economic Policy Secretary Marcos Lisboa presided over the second Group for Growth (GfG) meeting in Rio de Janeiro on April 19. The GfG is an outcome of the June 2003 summit meeting of Presidents Bush and Lula. The first GfG meeting was held in Washington in September 2003 and focused on productivity growth. This second meeting focused on infrastructure issues and access to credit, including micro credit, as well as on current prospects for growth in both countries. The U.S. delegation, led by U/S Taylor, included Treasury DAS Nancy Lee, DAS for Public Affairs Tony Fratto, Western Hemisphere Office Director Ramin Toloui, Brazil Desk Officer Stephanie Segal, Regional Treasury Attache Matthew Haarsager, Rio Econoff and Emboff. In addition to Levy and Lisboa, the Brazilian delegation was rounded out by Ministry of Finance staffers Aline Diegues and Daniel Silgemann. Additional presentations were made by Armando Castelar of Brazil's Institute for Applied Economic Studies, who spoke on infrastructure and investment, Elizabeth Wallace of the European Bank for Reconstruction and Development (EBRD), who outlined a micro-credit pilot project being implemented in Russia and former Soviet republics, and Carlos dos Santos of Brazil's technical assistance agency for small businesses (SEBRAE), who spoke on SEBRAE's role in the provision of micro-credit.

The Starting Point

¶3. (U) Lisboa gave an extensive briefing on Brazil's current economic situation and the GoB policy agenda. The 2002 crisis, he said, arose from a combination of external shocks with fiscal imbalances, which resulted in a sharp exchange-rate devaluation, acceleration of inflation, increased country risk, and difficulties rolling over public debt. The new GoB's macroeconomic stabilization effort has reduced inflation to an expected 6% in 2004, after a spike of 17.2% in 2003. The increase in interest rates necessary

to combat the sharp increase in inflation, however, led to reductions in real wages, a fall in domestic demand and ultimately to negative real GDP growth of 0.2% in 2003. Those factors notwithstanding, Lisboa pointed out that this result compared favorably to financial/payments crises in other countries such as Russia in 1998, Mexico in 1994 and Thailand in 1997, where the subsequent falls in GDP were much sharper, ranging from -4.9% in Russia to -10.5% in Thailand.

Successful Adjustment

¶4. (SBU) Lisboa pronounced GoB 2002/2003 stabilization efforts a success. The goal was to control inflation so as to stop the slide in real wages, reduce real interest rates, and mitigate sources of external vulnerability, thus laying a foundation for more sustainable growth. Fiscal adjustment was key to all these goals and was the first priority upon President Lula's entering office. The increase in Brazil's national tax burden, up from 28% in 1998 to 36% of GDP in 2003, has been the single most important long-term contributor to fiscal adjustment.

¶5. (SBU) Levy and Lisboa emphasized that Federal non-interest expenditures fell as a percentage of GDP in 2003, contributing to the adjustment. They admitted that it had occurred in large part through real reductions in the government wage bill. The fiscal adjustment (and the return of financial-market confidence), in turn, allowed an easing of interest rates. Real interest rates are now at their lowest since the Plano Real was introduced in 1994. External vulnerability had been reduced by sharply reducing the quantity of exchange-rate-linked public debt. Stellar export growth has reduced the net-external-debt-to-exports ratio from 3.6 in 1999 to 2.2 in 2004. The current account turned positive in 2003 for the first time since 1994 and is expected to remain so this year.

¶6. (SBU) The biggest challenge to fiscal sustainability, according to Levy, is the social-safety net. Brazil in 2002 paid out almost 11% of GDP on public and private sector pension benefits, a level comparable to that of Sweden, even though Sweden's retirement-age population, as a percentage of its workforce, is almost double that of Brazil. The issue is primarily with the private-sector (INSS) system, Levy said, as last year's reform of the public-sector pension system had halted the growth of the deficit in that system. Levy predicted that the GoB would be forced to make hard decisions in the near future, including a cap on pension benefits in the INSS system.

Current Growth Scenario

¶7. (U) Lisboa maintained there is considerable evidence that the economy has already returned to a growth trajectory. Industrial production of consumer durables, capital goods, and intermediate goods all recovered in the last quarter of 2003 and continued to grow in the first months of 2004 (although there was a drop in both consumer-durables and capital-goods production from January to February 2004). The retail-sales index shows a similar evolution. Unemployment data, Lisboa said, was mixed. The official unemployment rate, based on household surveys in only a few major cities, has risen. However, Lisboa opined that the increase was because many who had formerly stopped actively seeking work, thus falling off the statistical radar, are now hopefully re-entering the job force, swelling the ranks of the unemployed for purposes of the calculation. Other measurements, including surveys of hiring by firms, showed 3.37% growth in formal jobs from March 2003 to March
¶2004. Much of this job growth reported by firms was taking place outside the large urban centers, however, and so was not reflected in the official unemployment-rate calculation. Lisboa presented a breakdown showing job growth of 4% outside urban centers, much of this from agribusiness, and only 2.5% job growth in urban areas. This added up to almost 100,000 more jobs created, in absolute terms, outside of urban areas than in urban areas, he said.

Longer-Term Sustainability

¶8. (U) Macroeconomic indicators aside, Lisboa acknowledged that the microeconomic agenda is key to sustainable growth. One GOB priority is passage of the Public-Private Partnerships (PPP) law to attract private infrastructure investment. Lisboa added that the Finance Ministry has been working to eliminate barriers to entrepreneurship and to promote innovation. On the former front, Lisboa reported success in obtaining agreement from all but one of Brazil's states on a unified system and set of procedures for setting up a business. The next step is to obtain the same agreements from each of Brazil's 5000-plus municipalities. Lisboa hoped to complete this

painstaking task within another one to two years. The result would be a one-stop shop, allowing anyone to fill out one form to create a small business. Still under debate in the Senate, the bankruptcy law, modeled on the U.S. Chapter 11, aims to create a more rational system that better secures creditor rights while giving businesses a chance to emerge from bankruptcy whole, something that does not happen today. Reform of the competition law, also planned, would help create a more benign environment for small business.

¶9. (U) Levy argued that, at heart, the GoB's evolving industrial policy is "an innovation policy," aiming to strengthen a network of laboratories and create incentives for research and development work. A key part of this effort is to strengthen the Intellectual Property Institute (INPI) so as to clear the backlog of patent applications and give innovators some hope of securing their rights. Lisboa added that a new Innovation Law would allow professors and their universities to benefit from the profits of their own research, as U.S. universities do.

Access to Credit

¶10. (U) In the discussion about increasing access to credit, Levy and Lisboa outlined several macroeconomic and structural issues that contribute to Brazil's infamously high interest-rate spreads and difficulties of small firms' access to credit. The primary, well-known reason offered was that the Government's high borrowing needs crowd out private sector and consumer credit, forcing interest rates higher. While that problem may not be fixable in the near future, the GOB is attacking the problem from the other side, such as with a current bill which favors applying anti-trust laws in the financial sector. Other initiatives aim to improve the functioning of housing markets, including by creating a framework for new financial instruments and securitization of mortgages, and to require banks to share credit information with other financial institutions at the borrower's request (personal credit histories should improve a borrower's ability to shop among banks.)

¶11. (U) Carlos dos Santos, of the Federation of Industries' technical assistance agency for small businesses (SEBRAE), outlined the stark reality of access to credit by small businesses in Brazil. A government survey recently found that of 10 million micro-enterprises (those with 6 or fewer employees) in Brazil, most are informal and only 4.9% had access to credit. While formally-registered firms theoretically have a few more options, a survey of 400,000 small but formal businesses in Sao Paulo found that 79% had no access to banking credits. Those that could get financing often relied on supplier credits (64% of cases), state-owned banks (3%) or loan sharks (3%). Many entrepreneurs wind up using credit cards at usurious rates. When small businesses can get bank loans, they are at spreads of up to 43.5% above the base SELIC rate. Factors contributing to spreads were credit risk, taxes (up to a quarter of the spreads), lack of judicial enforcement of collateral, and lack of competition among banks, Santos said.

¶12. (U) Elizabeth Wallace, who manages a pioneering micro-credit program for the European Bank for Reconstruction and Development (EBRD), outlined the program's market-oriented approach to train banks and bankers in techniques to make micro-credit lending a profit center. The EBRD program leverages existing banking infrastructure but emphasizes training and technical assistance to alter banks' business models and loan-officers' mindsets as well as transfer credit technology, introduce credit analysis and streamline procedures. The program also stresses the importance of commercial pricing of loans, and of adequate scale to spread fixed costs in order to ensure the viability of micro-credit lending. Competition among micro-lenders to bring down spreads is also critical. The EBRD program has achieved costs as low as $59/loan in origination and administration fees, without sacrificing portfolio quality, a far lower rate than comparable programs administered by NGOs, asserted Wallace.

Infrastructure Investment

¶13. (U) Armando Castelar Pinheiro of the Institute for Applied Economic Studies noted that periods of higher investment rates have clearly been correlated with higher productivity growth in Brazil. Investment rates, however, declined significantly early in the 1980s. Subsequent economic reforms at the beginning of the 1990's helped increase investment rates and concomitant productivity growth, but investment still remains low in comparative terms, at 19% of GDP. The picture was further complicated in the late 1990's and early 2000's by increasing public deficits, which reduced public investment and soaked up private savings.

¶14. (U) Levy and Lisboa outlined steps the GoB is taking to increase savings and investment. It has created a new set of investment accounts that allow investors to rebalance their portfolios without being subjected to the financial transactions tax (CPMF). This should help reduce the CPMF's distortion of investment decisions. The GoB also has begun to exempt capital goods from the industrial production tax in hopes of encouraging firms to invest.

¶15. (U) The centerpiece of the GoB's efforts to increase investment is its draft law on Public-Private Partnerships (PPPs). The PPP bill, currently undergoing Senate scrutiny after passage in the Chamber of Deputies, would create a framework for long-term private investment in infrastructure to be paid back through user fees. Importantly, in cases where the return on the project is not sufficient to justify private investment, the public sector could subsidize the project or top-up the payment stream. A guarantee fund would give long-term security to the private investors. Castelar lauded those positive points of PPPs, but pointed out several problems with their application in the Brazilian context. These include the uncertainty over the conduct of Brazil's sometimes mercurial judges and over project jurisdiction, the absence of a sound regulatory framework in many sectors, as well as problems in obtaining environmental licenses (and judicial intervention in that process), and open questions regarding the appropriate budgeting/accounting treatment for PPPs. Uncertainty over the commitment of future administrations to PPP guarantees could be overcome if the public sector makes a sufficient down payment up-front, Castelar noted.

COMMENT

¶16. (SBU) This GfG meeting was characterized by candid discussion of Brazil's current economic situation and the challenges that the GoB's policy agenda faces. The discussion of the EBRD micro-credit experience in Eastern Europe and Eurasia provoked the most numerous and pointed questions from Levy and Lisboa, sparking discussion of what pieces might be applicable in the Brazilian context. The failure of many of Brazil's past micro-credit efforts make improving access to such credit a special limus test.

¶17. This cable cleared and coordinated with AmConGen Rio and Treasury.

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